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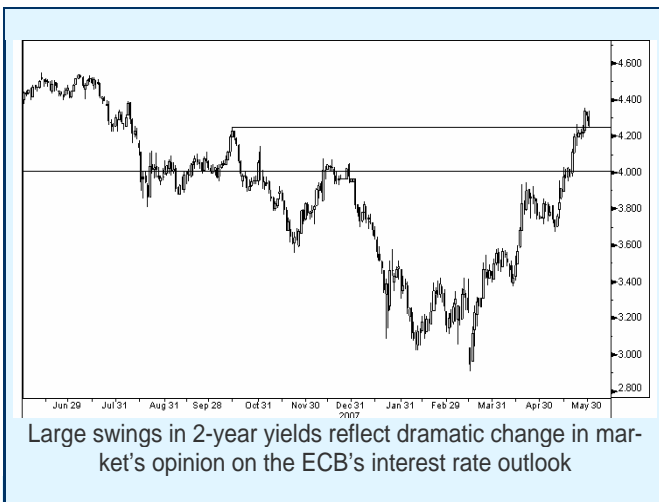
A hot inflation summer; can the ECB sweat it out?

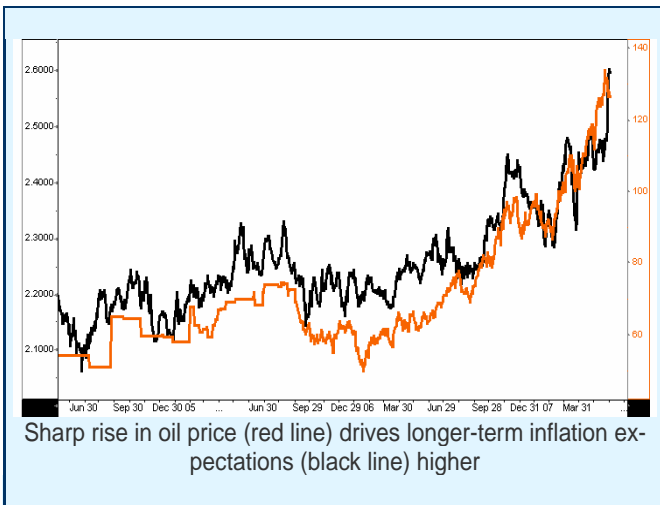
- Rising energy and food prices have dramatically changed the short-term inflation outlook and ...
- ... raise fears about an ECB rate hike around year end
- We however believe deteriorating growth outlook will prevent second round effects from materializing and expect inflation to fall back towards 2% till the end of 2009
- As such, we now expect rates to remain on hold this year and to fall to 3.50% next year

Concerns that the global economy may be facing its greatest inflation threat for decades have dramatically changed sentiment towards interest rates of late. For most of the early part of 2008, the risk of a sharp downturn in global economic activity had underpinned hopes for lower interest rates. However, financial markets now take the view that the risk of higher fuel and food prices spilling over into a more generalised deterioration in inflation will be the dominant influence on Central Banks words and actions. In the US, focus has turned to when and how quickly the Federal Reserve might raise policy rates. In the UK, traders think that stubbornly high inflation will prevent the Bank of England taking action to support a sharp deteriorating Economic outlook. In the Euro area, a rise in ECB rates is now predicted before end year.

Although we think that the prospect of a marked slowdown in the Euro area economic growth remains an issue for the European Central Bank, worries about inflation are an altogether more pressing concern. **Unless there is a broadly based deterioration in inflation we still think the next change in ECB policy rates will be a reduction however this is now a far more distant prospect than appeared likely even a month ago.** The sharp rise in energy costs in the interim means our earlier expectations of Autumn rate cuts no longer looks plausible. Indeed, there appears little prospect of an ECB rate cut before the end of the year. Instead, in the next couple of months fear about higher ECB rates could well intensify.

Although there has been some easing in oil prices in the past couple of days, **the sharp rise from below \$90 in the middle of January to \$135 in the past weeks has dramatically changed the outlook for Euro area inflation between now and end year.** More importantly, the sustained upward pressure on fuel and food costs threaten 'second round' increases in the prices of a range of other goods and services. This threat is also reflected in the recent sharp rise in longer-term financial inflation expectations derived from French inflation linked bonds. In recent days, the break even inflation rate derived from bonds with a maturity until 2020/21 set a new high at around 2.60%. **In such circumstances, the ECB's mandate requires that they talk tough and hold out the threat of a further increase in interest rates.** The tight relationship between oil prices and financial inflation expectations however also indicates that once oil prices fall, the inflation outlook may clear up pretty soon. Over the past two months, the price of several agricultural commodities, like wheat and rice, have already plunged lower reminding that commodities are no one-way bet. Nevertheless, until the risk of permanently higher inflation diminishes, markets will continue to focus on the possibility of a further increase in ECB rates.





Higher commodity costs mean the mid-year ECB staff projections to be released next Thursday are likely to show inflation averaging about 3.5 percent in 2008 and around 2.2 percent in 2009. This would imply inflation to peak at around 4% in the coming months and to remain around 3 percent until the end of this year and not drop close to the ECB target until the middle of next year. To fall back close to the 2% level at the end of next year, it's imperative that second-round effects on price-setting and on wages stemming from the current inflation rates can be avoided. Until now, core inflation has remained subdued in comparison with the headline inflation rate and even dropped to 1.6% Y/Y in April.

	ECB March staff projections	EU Commission forecasts	Survey of Professional Forecasters
Inflation '08	2.9%	3.2%	3.0%
Inflation '09	2.1%	2.2%	2.2%
GDP growth '08	1.7%	1.7%	1.6%
GDP growth '09	1.8%	1.5%	1.6%

We believe that the deteriorating growth outlook will prevent second round effects from materializing. Higher commodity costs won't only have an upward impact on the inflation outlook, but will also push economic growth further below trend, which is seen at around 2-2.25% in the Euro zone. In 2009, economic growth is likely to be revised down to at least 1.6%, which will increase spare capacity and reduce underlying inflationary pressures. In the end, this will lead to some easing in policy, although it will take longer than in previous cycles due to the strong price rises in internationally traded commodities.

Besides the short-term inflation outlook, the ECB will also keep a close eye on the monetary aggregates before deciding on interest rates. Like ECB's Stark last week pointed out in the FT, the monetary aggregates have been an extremely useful guide to set out the direction for monetary policy.

The sustained strength in money supply and credit growth data have helped the ECB to downplay the fears for a fully fledged 'credit crunch' in the Euro zone and keep rates unchanged since last Summer. The ECB bank lending surveys and historical relationships however suggest that the recent strength will prove short-lived and that at least credit growth will slow significantly in the months ahead.

Since the peak at 11.2% Y/Y last year, growth in loans to the private sector has slowed to 10.6% Y/Y in April. The resilience in private sector loan growth is mainly due to a sustained rise in loans to non-financial corporations, while growth in household loans has already fallen back to its lowest level since 2003. The April ECB bank lending survey however showed loan demand from enterprises plunging to its lowest level since 2003. This would be consistent with previous ECB research, which indicated that growth in household loans tend to turn earlier in the credit cycle than growth in corporate loans. Such a slowdown in the monetary aggregates in the second half of the year would improve the medium term inflation outlook and point to lower interest rates ahead.

Regarding Thursday's ECB meeting, Trichet is likely to continue talking tough on the upside inflation risks just like its mandate requires. This will keep the threat of higher interest rates alive. The ECB however knows that it can't do little about current elevated inflation levels, as current inflation is mainly 'made abroad' in the form of higher energy and food prices. As such, the main task of the ECB will be to prevent current elevated inflation levels to influence future price and wage-setting behaviour, which would result in a broad-based inflation problem. The main question is whether current interest rates are high enough to fulfil this objective. We still think so and expect interest rates to remain unchanged in the second half of the year and to decline in 2009 once it becomes clear that the inflation rate is falling back towards the 2% level. This rate forecast is based on the view that Euribor rates remain elevated compared to the official ECB rates, which contributes to a tighter policy stance than the official rates suggest. A sharp fall in the spread would significantly increase the risk for a rate hike. Like ECB's Weber mentioned last week, we see however no reason to expect such a fall anytime soon.

Hence, compared to current market expectations, which do discount a rate hike at around year end, we expect rates to remain unchanged at 4% and to fall around 50 bps next year. This implies that a long position can be considered at the short end of the curve. But before opening such a position, we however would like to see sentiment on the bond markets improving. A sustained fall below 4.25% in 2-year yields and 4.35% in 10-year yields would suggest that the worst is over on the European bond market.

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